No. 20073

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

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OIL BASE, INC.,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

---

ON PETITION FOR REVIEW OF THE DECISION OF THE

TAX COURT OF THE UNITED STATES

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BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

## OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (I-R. 26-51)[1/] are not officially reported.

## JURISDICTION

This petition for review (I-R. 59-61) involves federal income tax for the fiscal year ended September 30, 1959. On March 8, 1963, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiency in the amount of $51,718.66. (I-R. 1.) Within ninety

1/ "I-R." references are to Volume I of the reproduced record.

days thereafter, on June 4, 1963, the taxpayer filed a petition with the Tax Court for a redetermination of the deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (I-R. 1-7.) The decision of the Tax Court was entered January 12, 1965. (I-R. 58.) The case is brought to this Court by a petition for review filed March 30, 1965 (I-R. 59), within the three-month period prescribed in Section 7483 of the Internal Revenue Code of 1954. Jurisdiction is conferred on this Court by Section 7482 of that Code.

## QUESTION PRESENTED

Whether the Tax Court was correct in holding that the Commissioner properly included in taxpayer's income, under the provisions of Section 482 of the Internal Revenue Code of 1954, a portion of the commissions paid and discounts allowed to taxpayer's wholly owned foreign subsidiary.

## STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations involved are set out in the Appendix, infra.

## STATEMENT

Taxpayer is, and has been since prior to 1946, engaged in the business of manufacturing and selling oil base drilling fluid and related products to the oil drilling industry. Since such time, taxpayer has been selling its products in certain foreign countries where oil drilling activity was being conducted. (I-R. 27.)

Taxpayer's principal product is an oil base drilling fluid known as "Black Magic." Black Magic is a specialized product for use in the oil drilling industry which possesses certain qualities not found in water base drilling fluids. It produces highly desirable results in certain specialized oil well drilling situations. The product is more expensive than water base drilling fluids, is dirty, and is disagreeable to work with. For this reason taxpayer considers it necessary to direct its selling efforts to all levels of oil drilling personnel ranging from top level executives of the oil company down to the drilling crews. Generally, it requires more than one contract to result in a sale of taxpayer's product. (I-R. 27-28.)

Servicing the use of taxpayer's products after a sale is also an important feature of taxpayer's business. Taxpayer maintains a staff of service engineers whose main duty is to service and supervise the use of taxpayer's products by its customers. All of taxpayer's sales and service engineers are trained in the use of taxpayer's products and taxpayer's top executives are likewise trained. (I-R. 28.)

Prior to October 1, 1955, taxpayer's foreign sales had been accomplished through various independent sales representatives. (I-R. 28.) On or about October 1, 1955, taxpayer and Baritina de Venezuela, S.A., a Venezuelan corporation of Caracas, Venezuela (hereinafter referred to as Baritina), executed an agreement pursuant to which Baritina was to act as the exclusive sales

representative for taxpayer's products in the country of Venezuela. This agreement provided that Baritina would diligently and faithfully prosecute the sale of taxpayer's products, would forward to taxpayer all orders to be shipped by taxpayer directly to Baritina's customers, would pay its own costs and expenses, and would maintain at its own expense an adequate and competent staff of sales engineers in connection with the selling and servicing of taxpayer's products. It further provided that Baritina would send one or more persons to taxpayer's Compton, California, plant for instruction in the use and sale of taxpayer's products and that Baritina would not sell or attempt to sell any product similar to taxpayer's products without taxpayer's consent. The agreement also contained other general provisions with respect to liabilities of the parties, claims, and price of merchandise. (I-R. 28-29.) In addition, the contract contained the following provision with respect to Baritina's commissions and discounts (I-R. 29-30):

> 8. First Party (OIL BASE, INC.) agrees to pay to Second Party [Baritina] as commissions upon merchandise shipped directly by First Party to the customers within Second Party's territory, as hereinafter set forth under heading (a) of this paragraph contained; First Party does further agree to allow Second Party discounts from its list price of merchandise, hereinafter listed as

may be purchased by Second Party from First Party for resale and stocked or warehoused by it, as hereinafter set forth under headings (b) and (c) of this paragraph contained:

| | (a) (commission) | (b) Net 90 days from date of invoice (discount) | (c) Net 30 days from date of invoice (discount) |
|---|---|---|---|
| OB Wate | 15% | 17 1/2% | 20% |
| Filter Presses | 15% | 17 1/2% | 20% |
| Chemical "V" | 15% | 17 1/2% | 20% |
| OB Zero | 15% | 17 1/2% | 20% |
| Mix Fix | 15% | 17 1/2% | 20% |
| Additive "E" | 15% | 17 1/2% | 20% |
| Sacked Black Magic | 20% | 22 1/2% | 25% |
| OB Gel | 20% | 22 1/2% | 25% |
| OB Gen | 20% | 22 1/2% | 25% |
| White Magic | 20% | 22 1/2% | 25% |
| Economagic | 20% | 22 1/2% | 25% |
| Peptomagic | 20% | 22 1/2% | 25% |
| No-Glo Oil | 20% | 22 1/2% | 25% |
| No-Glo Thread Lubricant | 20% | 22 1/2% | 25% |
| Special Additive 58 | 20% | 22 1/2% | 25% |
| Formaseal | 20% | 22 1/2% | 25% |
| Mud Guns | 20% | 22 1/2% | 25% |
| Well Wash | 20% | 22 1/2% | 25% |
| Chemical "W" | 20% | 22 1/2% | 25% |
| Black Magic Premix | 20% | 22 1/2% | 25% |
| Hand Cleaner | 20% | 22 1/2% | 25% |

On or about December 1, 1955, taxpayer and Baritina executed a document entitled "Supplemental Agreement" pursuant to which the country of Colombia was added to the territory for which Baritina was to be the exclusive representative of taxpayer's products. This supplemental agreement further provided that A.Z. Export, S. A., was to be named as exclusive subagent and distributor of taxpayer's products in the Republic of Colombia. (I-R. 30.)

During the time that Baritina was representing taxpayer, taxpayer furnished Baritina one of its own experienced engineers who went to Venezuela and became employed by Baritina. This engineer, while employed by Baritina, worked primarily on sales of taxpayer's products. (I-R. 31.)

The agreement between taxpayer and Baritina remained in force through September 30, 1957. After this date, and during the period of time in which Baritina and taxpayer were negotiating in an effort to reach a new agreement, Baritina continued to sell taxpayer's products even though no written contract between the two parties was in effect. (I-R. 30-31.)

After the termination of the agreement between taxpayer and Baritina on September 30, 1957, the two companies negotiated for renewal and modification of the agreement. These negotiations consisted of correspondence between the two companies and one personal conference between representatives of taxpayer and a representative of Baritina. In these negotiations, taxpayer's representatives took the position that since 40 per cent of Baritina's stock had been acquired by National Lead Company (who operated a division called the Baroid Division which was a direct competitor of taxpayer) taxpayer should have protection with respect to the time period of the contract and the quantity of inventory carried by Baritina.[2/] In addition, taxpayer wanted

2/ Taxpayer wanted the contract to be for a term of five years and for Baritina to maintain a minimum inventory of $100,000. (I-R. 33.)

Baritina to erect a premix plant in order that taxpayer's products might be shipped in a dry state to Venezuela and mixed in liquid form in that country. Taxpayer also wanted Baritina to agree to send four or more persons to its plant in Compton for training. (I-R. 31-32.)

During the course of negotiations, Baritina requested higher commissions and discounts. At the personal conference between representatives of taxpayer and of Baritina, taxpayer's representatives received the impression that the representative of Baritina had authority to agree to a contract on behalf of Baritina and at the conclusions of the conference were under the impression that agreement had been reached between the two companies regarding the provisions of a new contract. In accordance with this understanding, taxpayer's president, under date of March 10, 1958, submitted to the general manager of Baritina a proposed new contract to be entered into between the two companies as of April 1, 1958, which proposed contract was understood to be in accordance with the agreement reached at the personal conference. (I-R. 32.) The proposed agreement submitted by taxpayer's president to Baritina with a letter, dated March 10, 1958, was for a period of one year and contained among

its provisions the following (I-R. 32-34):

(1) Baritina would agree to maintain at its own expense an adequate and competent staff of sales engineers in connection with the selling and servicing of Oil Base's products. In connection with the foregoing, Baritina would agree to send four or more persons to Oil Base's plant at Compton, California, within a period of 120 days from the date of the contract for instruction in the use, and sales procedures adopted by Oil Base in connection with the consumer use and sale of its products. All transportation, living, maintenance, and salary expenses of and for such persons were to be borne and paid by Baritina. Baritina, however, had the option, in lieu of sending the four persons for training at Oil Base's plant at Compton, California, to request Oil Base to send one of its trained engineers to Venezuela to train and instruct the four persons as sales engineers, all expenses of this representative of Oil Base, including salary, to be borne and paid by Baritina.

(2) Baritina would agree to maintain at all times during the existence of the agreement a minimum stock of Oil Base material in certain

described quantities which had a minimum purchase price of $100,000.

(3) In consideration of Oil Base paying certain commissions which had accrued to Baritina during the period when no contract between the two companies was in existence and which were in the amount of $15,000, Baritina would agree to erect immediately at its sole expense a premix plant in accord with blueprints furnished to Baritina by Oil Base. This premix plant was to be erected at Las Morochas, Venezuela, for use in the processing, storage and sale of Oil Base products.

(4) Baritina would agree to maintain two trained sales engineers in the Republic of Colombia at all times during the existence of the agreement.

The commissions and discounts set forth in the proposed agreement were identical to those which had been contained in the prior agreement between taxpayer and Baritina. The term of one year in the contract was in accordance with information which the assistant general manager of Baritina had given to representatives of taxpayer, subsequent to the personal conference between representatives of the two companies, to the effect that the general manager of Baroid Sales Division of National Lead Company would agree to a one-year term only in the contract. (I-R. 34.)

Subsequent to the submission of the proposed contract to Baritina, further correspondence took place between representatives of taxpayer and of Baritina in which the representatives of Baritina stated that Baritina could not agree to the new provisions of the proposed contract which required Baritina to keep a minimum inventory and to construct a premix plant in Venezuela. The estimated cost of the construction of the premix plant was approximately $25,000. (I-R. 34.)

In a letter, dated March 17, 1958, from the assistant general manager of Baritina to taxpayer's president discussing the proposed new contract, the following statement was made (I-R. 34-35):

> We are more than willing to continue on the basis of the old contract, making whatever new arrangements within reason which you feel are necessary in Columbia [sic]. This would mean putting at least one permanent sales and service representative in Bogota. In Venezuela, we must be clear in stating that we cannot agree to building a Mixing Plant or maintaining inventories at the present time.
>
> May we hope that you can see your way clear to extend the old contract or a modified form of the new contract excluding those portions commented on in the preceding paragraphs.

At the time the negotiations were being carried on with respect to the new contract between taxpayer and Baritina, the latter company was maintaining in Venezuela an inventory of taxpayer's products in the amount of approximately $85,000. (I-R. 35.)

The proposed new contract between taxpayer and Baritina was never executed and negotiations were terminated in April of 1958. (I-R. 35.)

After termination of negotiations between taxpayer and Baritina, taxpayer's management gave consideration to the best method of marketing taxpayer's products in foreign countries. After consulting counsel in Los Angeles, California, and in Venezuela, taxpayer's board of directors decided to form a wholly-owned Venezuelan corporation to act as taxpayer's sales representative in foreign countries. On or about July 13, 1958, taxpayer caused the formation of Oil Base de Venezuela, C.A., a Venezuelan corporation (hereinafter referred to Obvenca) as a wholly-owned subsidiary of taxpayer. Obvenca was organized with a paid-in capital of $6,000 and at no time during the fiscal year ending September 30, 1959, was this paid-in capital increased. (I-R. 35.)

On or about June 20, 1958, taxpayer and Obvenca executed an agreement pursuant to which Obvenca was to act as taxpayer's exclusive sales representative for the sale of taxpayer's products in all countries of the world except for the United States and the provinces and dominions of Canada. (I-R. 35-36.)

Section 8 of this agreement provided as follows (I-R. 36):

> 8. O.B.I. agrees to pay O.B. Ven., as commissions upon merchandise shipped directly by O.B.I. from any of its plants or warehouses located in the United States of America to a customer located within O.B. Ven.'s territory, such sum as represents twenty per cent (20%) of the net invoice billings of said sales, exclusive of transportation, packaging, insurance, and taxes, of those products of O.B.I. known as OB Wate, Filter Presses, Additive "V", OB Zero, MixFix, Additive "X" and Additive "E"; and such sum as will represent fourty per cent (40%) of the net invoice billings of sales, exclusive of transportation, packaging, insurance and taxes, of all of O.B.I.'s products. O.B.I. does further agree to allow O.B. Ven. discounts of twenty per cent (20%) from its established export list price of its products, exclusive of freight, taxes and special charges for export crating, known as OB Wate, Filter Presses, Additive "V", OB Zero, MixFix, Additive "X" and Additive "E"; and discounts of forty per cent (40%) from its established list price, exclusive of freight, taxes and special charges for export crating, on all other of O.B.I.'s products. If such commissions are due O.B. Ven. because of direct purchases made from O.B.I. by customers operating in O.B. Ven.'s territory as aforedescribed, such commissions shall be determined and paid on the 20th day of the month next succeeding the month in which payment is made to O.B.I. by such customers.

The agreement between taxpayer and Obvenca was for the period commencing June 20, 1958 and ending January 1, 1959. (I-R. 36.) This agreement was extended for an additional year to December 31, 1959. (I-R. 36.) The agreement between taxpayer and Obvenca did not require Obvenca to maintain a minimum inventory, to erect a premix plant, to send four sales engineers for training at taxpayer's plant, or to maintain two sales engineers in Colombia. (I-R. 36-37.)

On July 1, 1958, Obvenca entered into a written agreement with M. R. Vollmer and M. L. Cooper who are referred to in the agreement as Volco. Under this agreement Volco was designated as the exclusive sales representative of taxpayer's products in the country of Colombia. Under the provisions of this agreement, Volco was to receive a ten per cent commission on products shipped directly by Obvenca to customers within the country of Colombia. This agreement obligated Volco to maintain two trained sales engineers in the Republic of Colombia at all times during the existence of the agreement. (I-R. 37.)

By assignment agreement, dated November 24, 1958, the agreement between Obvenca and Volco was assigned to Volco, Inc., a Panamanian corporation. Volco, Inc., was a corporation formed by M. R. Vollmer and M. L. Cooper. The assignment was agreed to by Obvenca. Prior to July 1, 1958, M. R. Vollmer and M. L. Cooper were representatives of an agent of Baritina in the Republic of Colombia and in that capacity sold and serviced taxpayer's products in Colombia. (I-R. 37.)

On October 1, 1958, Obvenca entered into an agreement with Servicios Petroleros, S.A., a Peruvian corporation (hereinafter referred to as Servicios), under which Servicios was designated as the exclusive sales representative of taxpayer's products in the country of Peru. This contract provided for the same commissions and discounts which had been provided for in taxpayer's contract with Baritina and in the proposed contract of April 1, 1958, between taxpayer and Baritina. (I-R. 37-38.)

On October 1, 1958, Obvenca entered into an agreement with Gene L. Towle, under which Towle was designated as exclusive sales representative of taxpayer's products in Mexico. This contract provided for the same commissions and discounts which had been provided for in taxpayer's contract with Baritina and in the proposed contract of April 1, 1958, between taxpayer and Baritina. (I-R. 38.)

Contracts between Obvenca and its three subagents were each signed by the president of Obvenca, who was also taxpayer's president. (I-R. 38.)

The agreement between Obvenca and Volco, Inc., covering the period beginning July 1, 1959 and ending September 30, 1960, provided for commissions to be paid and discounts to be allowed to Volco, Inc., in the same amounts as had been allowed by taxpayer to Baritina and as were being then allowed to Servicios and Gene Towle. (I-R. 38.)

On October 1, 1958, taxpayer and Milwhite Mud Sales Company, Ltd. (hereinafter referred to as Milwhite), entered into a contract under which Milwhite was designated as exclusive sales representative for taxpayer's products in the provinces of Alberta and Saskatchewan, Canada. Commissions and discounts allowed to Milwhite under this contract were exactly the same as those which had been allowed by taxpayer to Baritina and which were set forth in the proposed contract of April 1, 1958 between

taxpayer and Baritina. Taxpayer's agreement with Milwhite was for a one-year period and was extended for an additional period to October 1, 1960. (I-R. 38-39.)

During the period beginning June 20, 1958, and continuing until about December 20, 1958, Richard Newman was the only full-time employee of Obvenca. Newman was stationed in Puerto La Cruz, Venezuela. Prior to being employed by Obvenca, Newman had been employed as a sales engineer by Baritina in Venezuela and in that capacity had sold and serviced taxpayer's products. Prior to becoming employed by Baritina, Newman had been employed as a sales engineer for taxpayer. Newman severed his connection with Obvenca about December 20, 1958. A period of approximately two weeks expired before Newman's replacement arrived in Puerto La Cruz, Venezuela. (I-R. 39.)

Newman's replacement was a man named White who had been employed by taxpayer prior to becoming employed by Obvenca. White took over his duties with Obvenca shortly after January 1, 1959. White was the only full-time employee of Obvenca from the time he became so employed throughout the balance of the fiscal year ending September 30, 1959. Newman, while being employed by Obvenca, and White, when he replaced Newman, served as sales engineer, service engineer, and general manager of Obvenca. (I-R. 39.)

Shortly after Obvenca was organized, a public accountant located in Venezuela was paid $75 to open a set of books for the newly organized corporation. It was agreed that this accountant would be paid for bookkeeping service by the corporation, and with no additional charge would permit Obvenca to use his post office box number in Puerto La Cruz and space in his office for the general manager of Obvenca to occupy from time to time. This accountant had other clients besides Obvenca. It was agreed that the payment for services, without any additional charge for the post office box and the furnishing of an office, would be approximately $150 per month. The accountant's practice, with whom Obvenca made the arrangements,was purchased around the first of May, 1959. The accounting firm which purchased the practice continued the same arrangement with Obvenca. (I-R. 39-40.)

During the fiscal year ended September 30, 1959, the president and vice president of taxpayer, who were also the president and executive vice president of Obvenca, made a trip to Venezuela, and during the course of the trip visited Mexico and Colombia. In the business dealings conducted in Venezuela, they represented themselves as officers of Obvenca. During some of the trip, the two officers were accompanied by Newman, the manager of Obvenca. On the trip in Colombia, taxpayer's two officers represented themselves as officers of Obvenca. They were accompanied by the Colombian agents who handled the taxpayer's

products. In accordance with the agreement between Obvenca and taxpayer, each of the companies bore one-half of the expense of the trip made by these officers to Venezuela, Colombia and Mexico. (I-R. 40.)

It had been taxpayer's consistent practice during the years it was marketing its products in foreign countries to send employees to the countries in which the products were being sold for the purpose of assisting its sales representatives in servicing the use of its products. Taxpayer's assistant sales manager was usually the representative sent to Venezuela and Colombia and while on such trips he went to the site where taxpayer's products were being used and serviced the use of taxpayer's products. The expense of these trips was borne solely by taxpayer. (I-R. 41.)

As of September 30, 1958, Obvenca had inventory of a value of $21,809 stored at a leased warehouse in Puerto La Cruz, Venezuela; and as of September 30, 1959, it had inventory stored in this warehouse of a value of $27,764. As of these same dates Obvenca owned office equipment which had a cost of $758 and an automobile which had a cost of $3,611; and as of September 30, 1959, Obvenca owned the furniture for a manager's house which had a cost of $1,200. (I-R. 41.)

During the fiscal period ended September 30, 1958 and the fiscal year ended September 30, 1959, Obvenca leased a warehouse in Puerto La Cruz for Bs. 500 per month. During the fiscal year 1959 it required three and one-third Bolivars (Bs.) to equal one United States dollar. (I-R. 41.)

During the fiscal period ended September 30, 1958 and the fiscal year ended September 30, 1959, Obvenca leased a manager's house located at Phillips Camp at San Roque, Venezuela, for a monthly rental of Bs. 800 and a house located at Nalco Camp, Anaco, for a monthly rental of Bs. 1,000. (I-R. 41-42.)

For the fiscal year ended September 30, 1959, Obvenca was charged (for services rendered) $3,136.33 and $1,055.33 of the salaries paid by taxpayer to its president and vice president, respectively, who were also the president and executive vice president of Obvenca. In addition, taxpayer's treasurer also rendered services for Obvenca and for services rendered by the individual who was taxpayer's treasurer until July, 1959, Obvenca was charged $275.40 and for services rendered by the individual who became taxpayer's treasurer on July 1, 1959, Obvenca was charged $117.63 for the fiscal year ended September 30, 1959. (I-R. 42.)

Obvenca had income and retained earnings of $18,208 for the three and a half-month period ended September 30, 1958, a net income of $81,031 for the fiscal year ended September 30, 1959, and retained earnings of $99,239 for the fiscal year ended September 30, 1959. Taxpayer's direct profit from sales for its fiscal years ending September 30, 1956, 1957, 1958 and 1959 expressed as a percentage of total gross sales, the direct profit from domestic sales expressed as a percentage of those sales, and export sales expressed as a percentage of such sales are as follows (I-R. 42-43):

| | Fiscal Years Ended September 30 | | | |
|---|---|---|---|---|
| | 1956 | 1957 | 1958 | 1959 |
| | Percent | | | |
| Total | 24.7 | 21.6 | 32.0 | 23.0 |
| Domestic | 22.4 | 14.0 | 21.2 | 22.5 |
| Export | 34.6 | 30.1 | 45.6 | 23.9 |

Direct profit used in computing these percentages represents the profit after deducting from gross sales all discounts and commissions allowed; manufacturing cost of goods sold; any patent royalties paid with respect to the goods sold; and the direct selling expenses including salesmen's expenses, salaries, and entertainment expenses. (I-R. 43.)

Throughout the fiscal year ended September 30, 1959, taxpayer owned all the outstanding capital stock of Obvenca. (I-R. 43.)

Each of the officers and directors of Obvenca was also an officer of taxpayer. (I-R. 43.)

In May of 1958, which was prior to the organization of Obvenca, taxpayer's representatives made a trip to Venezuela and Colombia at which time he discussed with Newman, who was then employed by Baritina, employment in Venezuela by taxpayer's proposed subsidiary. He also discussed with Vollmer and Cooper their serving as sales representatives for taxpayer's products in Colombia. At that time Vollmer and Cooper were employees of a subagent who was a distributor of taxpayer's products in Colombia on behalf of Baritina. (I-R. 43.)

Certain officers of taxpayer, who were also officers of Obvenca, carried on extensive correspondence on behalf of Obvenca from taxpayer's office in Compton, California. Although the letterhead of Obvenca was used in this correspondence, such correspondence was actually written in Compton, California, by secretaries who were full-time employees of taxpayer. (I-R. 43-44.)

During the fiscal year ended September 30, 1959, between 80 and 85 per cent of the sales of taxpayer's products in the Republic of Colombia were made to Texas Petroleum Company in Colombia. Some of the sales resulted from orders sent by Texas Petroleum Company's New York City office to taxpayer in Compton, California, with directions that the order be shipped to the Texas Petroleum Company in Colombia. Taxpayer would then prepare documents showing taxpayer as the shipper and Texas Petroleum Company, Colombian Division, as the consignee and purchaser. (I-R. 44.)

Taxpayer on its federal income tax return for its fiscal year ended September 30, 1959 reported taxable income of $20,457.80. (I-R. 44.)

The Commissioner of Internal Revenue in his notice of deficiency, in addition to making adjustments which though originally in issue in the petition in this case have been disposed of by agreement of the parties, increased taxpayer's reported income by the amount of $106,699.14 designated as "Sales increased" and made the following explanation of this adjustment (I-R. 44-45):

> It is determined that commissions paid and discounts allowed to your controlled foreign subsidiary, Oil Base de Venezuela, C.A. were excessive in amount and had the effect of improperly shifting income from you to your controlled foreign subsidiary, thereby

> distorting your income and the income of your subsidiary. Furthermore, sales commissions were paid to Oil Base de Venezuela on certain sales occurring outside of Venezuela which were, in substance, your sales and on these sales no commissions are being allowed under this determination. In determining the proper amount allowable as commissions and discounts paid to Oil Base de Venezuela, C.A. where some amount is properly allowable, the determination has been based on arm's length negotiated rates between yourselves and uncontrolled parties on identical goods and services. This issue involves application of sections 61 and 482 of the Internal Revenue Code of 1954.

The Tax Court held that the record evidence was such as to indicate that a fair and reasonable commission and discount to be allowed Obvenca on the sales it made of taxpayer's products in Venezuela was the amount of commission and discount that had been allowed to Baritina, was proposed in the new contract to be allowed to Baritina, and which was allowed to taxpayer's Canadian representative and to Obvenca's various subagents. (I-R. 50.)

As for the sales made in Colombia, Mexico and Peru, the Tax Court found taxpayer to have shown no evidence of any services being performed by Obvenca which would entitle it to a profit on these sales. Accordingly, the Tax Court held that the rates of commissions and discounts allowed by the Commissioner with respect to taxpayer's Venezuelan sales were also proper with respect to all sales of taxpayer's products in Colombia, Mexico

and Peru made through Obvenca during the fiscal year ended September 30, 1959, in computing the amount of the commissions paid by taxpayer to its subsidiary which were properly deductible by taxpayer in determining its taxable income for its fiscal year 1959. (I-R. 51.)

## SUMMARY OF ARGUMENT

Section 482 of the Internal Revenue Code of 1954 authorizes the Commissioner, in any case of two or more businesses controlled by the same interests, to distribute, apportion or allocate gross income, deductions, credits or allowances between such businesses if he determines that it is necessary in order to prevent evasion of taxes or clearly to reflect income. The purpose of this section is to place controlled taxpayers on a parity with uncontrolled taxpayers by determining the true net income of a controlled taxpayer through application of the standard of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

The commissions paid and discounts allowed by the taxpayer to its wholly owned subsidiary were far in excess of those which would have been allowed had the contract been entered into between the taxpayer and an uncontrolled organization; and were in fact far in excess of commissions and discounts made available to an independent party who became taxpayer's Canadian representative shortly after taxpayer's contract with its subsidiary went into effect.

The Commissioner contends that the proper criteria to be used here in allocating income to the taxpayer were those rates of commissions and discounts which taxpayer allowed to its Canadian representatives, which taxpayer had allowed to its Venezuelan representatives prior to taxpayer's contract with its subsidiary and which were allowed by taxpayer's subsidiary to its contractual subagents.

The allocation so made by the Commissioner may be overturned only if shown by the taxpayer to have been arbitrary, capricious or unreasonable. The determination as to whether or not the Commissioner has exceeded or abused his discretion is factual in nature and should not be set aside unless clearly erroneous.

## ARGUMENT

### I

### SECTION 482 IS A GRANT OF ADMINISTRATIVE DISCRETION TO ALLOCATE DEDUCTIONS AMONG CONTROLLED BUSINESSES, THE EXERCISE OF WHICH MUST BE SUSTAINED IN THE ABSENCE OF CLEAR ABUSE

Section 482 of the Internal Revenue Code of 1954 (Appendix, *infra*) provides in pertinent part, that in any case of two or more businesses controlled by the same interests, the Secretary of the Treasury or his delegate may distribute, apportion or allocate gross income, deductions, credits, or allowances between such businesses if he determines that it is necessary

in order to prevent evasion of taxes or clearly to reflect their income. Section 482 is substantially the same as its predecessor, Section 45 of the Internal Revenue Code of 1939, which has its origin, as explained in National Securities Corp. v. Commissioner, 137 F. 2d 600, 602 (C.A. 3d), certiorari denied, 320 U.S. 794, in Section 240 of the Revenue Act of 1926, c. 27, 44 Stat. 9, which authorized affiliated corporations to file consolidated returns. Subsection (f) of Section 240 authorized the Commissioner of Internal Revenue "in any case of two or more related trades or businesses* * *owned or controlled directly by the same interest to consolidate their accounts if necessary in order to make an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses." The Revenue Act of 1928, c. 852, 45 Stat. 791, eliminated the right of affiliated corporations to file consolidated returns and in the place of Section 240(f), Congress added Section 45 which, as the report of the House Ways and Means Committee pointed out, was based upon Section 240(f) of the 1926 Act "broadened considerably in order to afford adequate protection to the Government made necessary by the elimination of the consolidated returns provision of the 1926 Act." H. Rep. No. 2, 70th Cong., 1st Sess., p. 16 (1939-1 Cum. Bull. (Part 2) 384, 395).

The purpose of Section 482 is, as explained by Section 1.482-1(b)(1), Treasury Regulations on Income Tax (Appendix, _infra_), to place controlled taxpayers on a tax parity with uncontrolled taxpayers by determining the true net income of a controlled taxpayer through application of the standard of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. The authority to determine true net income extends to any case in which either by inadvertence or design, the taxable net income is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. _Commissioner_ v. _Chelsea Products_, 197 F. 2d 620, 623 (C.A. 3d). That is, whenever the lack of an arm's length relationship produces a different economic result from that which would ensue in the case of two uncontrolled taxpayers dealing at arm's length, the Commissioner is authorized to allocate gross income and deductions. _Commissioner_ v. _Chelsea Products_, _supra_; _Aiken Drive-In Theatre Corp._ v. _United States_, 281 F. 2d 7 (C.A. 4th); _Spicer Theatre, Inc._ v. _Commissioner_, 346 F. 2d 704 (C.A. 6th); _Simon J. Murphy Co._ v. _Commissioner_, 231 F. 2d 639 (C.A. 6th).

Litigation under the statute has shown that Section 482 has been applied to circumstances which involve an improper manipulation of financial accounts, an improper juggling of accounts

between the related businesses, an improper "milking" of one business for the benefit of the other or some similar abuse of proper financial accounting which was made possible by the control of the two businesses by the same interests. _Spicer Theatre, Inc_. v. _Commissioner_, _supra_; _Simon J. Murphy Co_. v. _Commissioner_, _supra_; _Asiatic Petroleum Co_. v. _Commissioner_, 79 F. 2d 234 (C.A. 2d), certiorari denied, 296 U.S. 645; _Rooney_ v. _United States_, 305 F. 2d 681 (C.A. 9th).

Section 482 attempts to recognize the normal tax effect of bona fide business transactions between separate organizations even though controlled by the same interest while at the same time enabling the Commissioner to change the bookkeeping effect of a transaction between controlled taxpayers when, by reason of the relationship, they arbitrarily or improperly shift income or deductions from one organization to another. _Simon J. Murphy Co_. v. _Commissioner_, _supra_. It is well settled that the dominant purpose of the revenue law is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. _Helvering_ v. _Horst_, 311 U.S. 112, 119; _Shaw Construction Co_. v. _Commissioner_, 323 F. 2d 316, 320 (C.A. 9th).

By virtue of Section 482, the Commissioner is vested with broad discretion and a determination made by the Commissioner should be overturned only if shown by the taxpayer to have been arbitrary or unreasonable. _Helvering_ v. _Taylor_, 293 U.S. 507; _G.U.R_. v. _Commissioner_, 117 F. 2d 187 (C.A. 7th); _Ballentine Motor Co_. v.

Commissioner, 321 F. 2d 796 (C.A. 4th); Campbell County State Bank, Inc. of Herreid, S.D. v. Commissioner, 311 F. 2d 374 (C.A. 8th); Spicer Theatre, Inc. v. Commissioner, supra; National Securities Corp. v. Commissioner, supra; Grenada Industries, Inc. v. Commissioner, 202 F. 2d 873 (C.A. 5th), certiorari denied, 346 U.S. 918.

A determination as to whether or not the Commissioner has exceeded or abused his discretion turns upon questions of fact and as such is subject to limited review. Ballentine Motor Co. v. Commissioner, supra; Commissioner v. Chelsea Products, supra; Hall v. Commissioner, 294 F. 2d 82 (C.A. 5th). In addition, the question whether the income was earned by taxpayer or by its subsidiary is, at least primarily, the determination of a question of fact (Ballentine Motor Co. v. Commissioner, supra; Campbell County State Bank, Inc. of Herreid, S.D. v. Commissioner, supra; Advance Machinery Exch. v. Commissioner, 196 F. 2d 1006 (C.A. 2d), certiorari denied, 344 U.S. 835) and in order to persuade this Court to reverse the findings of the Tax Court, taxpayer must show that such findings were clearly erroneous (Commissioner v. Duberstein, 363 U.S. 278).

Under the facts and circumstances of the instant case, the findings and conclusions of the Tax Court to the effect that the Commissioner did not abuse his discretion or act arbitrarily, capriciously, or unreasonably in invoking and applying Section 482 are satisfactorily supported by the record evidence and should not be disturbed.

## II

## THE TAX COURT CORRECTLY HELD THAT THE COMMISSIONER PROPERLY INCLUDED IN TAXPAYER'S INCOME, UNDER THE PROVISIONS OF SECTION 482 OF THE INTERNAL REVENUE CODE OF 1954, A PORTION OF THE COMMISSIONS PAID AND DISCOUNTS ALLOWED TO TAXPAYER'S WHOLLY OWNED FOREIGN SUBSIDIARY

The Commissioner is not here taking issue with the right of a parent and a subsidiary company to contract with each other so long as the contract is one which they would have entered into with an uncontrolled organization. The facts here, however, fully support the determination of the Commissioner that the commissions paid and the discounts allowed to the subsidiary were far in excess of those which would have been granted had the contract been entered into between the taxpayer and an uncontrolled organization; which commissions and discounts were in fact far in excess of those commissions and discounts made available to an independent party who became taxpayer's Canadian representative shortly after the OBI-Obvenca contract went into effect.

Prior to the contract with Obvenca, taxpayer had entered into a contract with Baritina for the sale and service of its products in Venezuela and Colombia. (I-R. 28, 30.) The commission to be allowed to Baritina on the bulk of the products which it sold was to be 20 per cent with a discount on the same products being 25 per cent. (I-R. 30.) This contract expired in 1957 and negotiations for its renewal began then. (I-R. 30.) Taxpayer, for various

business reasons, felt that additional requirements should be placed upon Baritina under the new contract. The additional requirements included locating two sales engineers in Colombia (I-R. 34), having two additional sales engineers in Venezuela (I-R. 32), having a minimum inventory of taxpayer's stock in the amount of $100,000 (I-R. 33),[3/] erecting a premix plant in the Maracaibo area (I-R. 33)[4/] and entering into a five-year contract instead of one year (II-R. 45).[5/] Taxpayer, however, did not feel that a higher commission or discount rate should be allowed to Baritina even in light of the additional burden which taxpayer was asking Baritina to carry. For, taxpayer's president stated at the trial that if Baritina sold taxpayer's products properly, Baritina could make an adequate profit on the commissions and discounts presently existing. (II-R. 48.)

A tentative agreement was reached as to all the proposed points of the contract with the exception of the five-year term. (I-R. 32-34.) Somewhat later, Baritina notified taxpayer that it could not agree to the requirements of a minimum inventory or the construction of a premix plant because of local and international developments

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3/ Baritina at that time had approximately $85,000 of inventory on hand. (I-R. 35.)

4/ The estimated construction cost of the premix plant was approximately $25,000. (I-R. 34.)

5/ "II-R." references are to Volume II of the reproduced record.

which affected oil production. Baritina did, however, express willingness to continue on the basis of the discounts and commissions as set forth in the old contract (I-R. 34-35) and stated that "our association in the past has been mutually profitable, and can see no reason why things should not continue to be so" (Ex. 4-d, p. 11).

Contract negotiations were discontinued with no agreement having been reached. Taxpayer then decided to organize Obvenca as a foreign subsidiary. Accordingly, Obvenca was organized with a paid-in capital stock of only $6,000. (I-R. 35.)

George Miller, as president of taxpayer and of Obvenca, signed the contract between taxpayer and Obvenca. This contract (Ex. 6-f) did not contain any of the additional requirements which had appeared in the contract offered to Baritina by taxpayer. That is, Obvenca was not required to maintain a minimum inventory, erect a premix plant or to have a set number of sales engineers on its staff. Moreover, the contract was to be for a period of only six months. (I-R. 39-40.) However, in spite of the lack of the above requirements, taxpayer agreed to pay Obvenca a 40 per cent commission on those items which constituted the bulk of the sale of taxpayer's products instead of the 20 per cent commission offered to Baritina and rather than the 22 1/2 per cent discount offered to Baritina, Obvenca was to receive a 40 per cent discount on the

above products. (I-R. 36.)[6]

Taxpayer attempts to justify the fact that the commissions and discounts offered to Obvenca were about twice the amount it had allowed Baritina by stating that its board of directors considered a number of factors in arriving at the rate of commissions and discounts to be allowed Obvenca. Among the factors which taxpayer stated were considered were that Baritina had represented to taxpayer that they were just about breaking even, that Obvenca would be handling taxpayer's products exclusively whereas Baritina handled non-competing products of many manufactuers and thus had a broader base over which to spread its cost, that Obvenca would be "starting from scratch" whereas Baritina was an established and going concern, the manufacturing cost of the products, the high cost of operating in Venezuela and Colombia, and that it would be necessary for Obvenca to obtain subagents and distributors in various foreign countries. (I-R. 48.)

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6/ The full significance of the 40 per cent commission and discount can only be appreciated by a realization that of the total sales of $264,259.47 during the fiscal year in question, a commission of 40 per cent was paid on sales of $261,423.76, while a 20 per cent commission was paid on sales of only $2,835.71. (Ex. 26-P.) Discounts were allowed to Obvenca on sales in the amount of $147,100.48. Forty per cent discounts were allowed on sales of $136,722.50; thirty per cent discounts were allowed on sales of $2,097.50; twenty per cent discounts were allowed on sales of $7,005.75; and sixty per cent discounts were allowed on sales of $1,274.73. (Ex. 27-Q.)

The Commissioner contends and the Tax Court found (I-R. 49) that none of the above-recited factors justified the rate of commissions and discounts allowed to Obvenca. A consideration of each factor will show the findings of the Tax Court to be correct.

First, taxpayer attempted to impose certain additional requirements in the proposed contract with Baritina which were not present in the old contract without offering Baritina a higher rate of commissions or discounts. Thus, it would seem that taxpayer did not believe that Baritina was just about breaking even under the old contract. This is clearly illustrated by the fact that taxpayer's president said that if its products were handled properly by Baritina, Baritina could make an adequate profit under the existing rate of commissions and discount. (II-R. 48.)

Second, Obvenca was a newly-formed corporation with absolutely no experience of doing business in Venezuela, with no established managerial or sales staff, with no office or post office box of its own, with only one full-time employee and was completely without the physical assets necessary to enable it to function as the taxpayer's sales representative in Venezuela or any other foreign country. It was in essence an almost shell-like subsidiary. Yet, from these facts taxpayer contends that Obvenca was entitled to higher commissions and discounts than Baritina which was adequately staffed and equipped to handle taxpayer's products. Such a contention flies in the face of all logic and reason. The

Commissioner contends that under such facts Obvenca was not entitled to higher rates of commissions and discounts than those offered Baritina and that in view of such facts a logical argument could even be made that Obvenca should have been offered lower rates of commissions and discounts than were paid and offered to Baritina.

Third, the fact that the manufacturing costs and selling prices of its products were known to taxpayer does not justify higher commissions and discounts being given to Obvenca than to Baritina. These costs were known at the time negotiations were being had with Baritina and no evidence was introduced to show that these costs were any different during the negotiation period with Baritina than they were when, shortly thereafter, the contract with Obvenca was signed. The only inference that can be drawn is that taxpayer was attempting to shift income to Obvenca.

Fourth, if the costs of operating were high in Venezuela and Colombia they would be as high for Baritina as for Obvenca. Moreover, at the time the contract was entered into with Obvenca, taxpayer was aware of what the costs would be in Colombia as negotiations had already been had with Volco as to its becoming the Colombian representative for Obvenca when Obvenca was formed. Within a few weeks after the OBI-Obvenca contract was formalized, a contract between Obvenca and Volco was entered into. Under the

provisions of this contract, Volco was to receive only a 10 per cent commission on taxpayer's products.[7] (I-R. 37.) Thus, Obvenca's operating costs with regard to sales in Colombia were set and were at a minimal level. Furthermore, Obvenca's manner of operation in Venezuela had been set prior to its incorporation. Arrangements had been made with Richard Newman, a Baritina employee who had handled taxpayer's products, to be Obvenca's sole full-time employee in Venezuela. (I-R. 49.)[8] Thus, taxpayer was well aware of what it was going to cost for Obvenca to operate in Venezuela and Colombia and in the skeletal form in which taxpayer intended Obvenca to operate, the operating costs would be at a minimum

Finally, as to the last factor considered, it was not shown by taxpayer why Obvenca should have any profit on sales made by its subagents as no evidence was introduced to show that Obvenca, as opposed to taxpayer, was responsible for any sales made in any country other than Venezuela.

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7/ The contract also required Volco to maintain two sales engineers in the country of Colombia. This is in contrast to the one full-time employee of Obvenca who taxpayer felt was capable of performing all of Obvenca's selling duties alone.

8/ Newman had been employed by taxpayer before going with Baritina to handle taxpayer's products.

Moreover, the contract which taxpayer entered into on October 1, 1958[9] with Milwhite Mud Sales Company, Ltd. (under which Milwhite was designated as taxpayer's exclusive sales representative for taxpayer's products in the Provinces of Alberta and Saskatchewan, Canada), called for the same rates of commissions and discounts to be paid to Milwhite as were paid to Baritina under the old contract and which were proposed to be paid under the new contract. The Milwhite contract thus clearly indicates that the commissions paid and discounts allowed to Obvenca were greatly in excess of those which would have been agreed upon had taxpayer and Obvenca dealt with each other at arm's length.

Furthermore, on the same day that taxpayer entered into its contract with Milwhite, Obvenca entered into a contract with Servicios Petroleros, S.A., a Peruvian corporation, under which Servicios was designated the exclusive sales representative of taxpayer's products in Peru. This contract provided for the same commissions and discounts which had been provided for in taxpayer's contract with Baritina and in the proposed contract between taxpayer and Baritina. (I-R. 37-38.) Also, on that same day, Obvenca entered into an agreement with Gene L. Towle, under which Towle was designated as the exclusive sales representative of taxpayer's products in Mexico. This contract provided for the

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9/ This was only three months after the OBI-Obvenca contract was formalized.

same commissions and discounts as had been allowed to Baritina and which were contained in the proposed contract between taxpayer and Baritina. (I-R. 38.) These contracts also clearly demonstrate that the commissions and discounts allowed Obvenca by taxpayer were not those which would have been reached by independent parties bargaining at arm's length. Thus, the Commissioner submits that the commissions and discounts allowed by Obvenca to its subagents and by taxpayer to Milwhite were the proper criteria to be applied in reallocating income shifted to Obvenca by taxpayer through the allowance of excessive commissions and discounts.

Through such arbitrary shifting of income and by the absorption of officers' salary expense by taxpayer,[10] Obvenca, with capital of only $6,000 was able to report net income and retained earnings of $18,208 for the three and a half month period ending September 30, 1958, net income of $81,031 for its fiscal year ended September 30, 1959, and retained earnings of $99,239[11] for the fiscal year ended September 30, 1959. (I-R. 42.) Taxpayer, on the other hand, due to such shifting of income and absorption of officers' salary expense was able to report net income of only $20,456.80 for the fiscal year ended September 30, 1959. (Ex. 16-P, Sch. 1.) Thus,

10/ For the fiscal year ended September 30, 1959, taxpayer had salary expense for its officers in the amount of $93,267.16. (Ex. 16-P, Sch. 3.) Of this amount, Obvenca was charged only $4,584.69 for services rendered by taxpayer's president and vice-president (who were also the president and vice-president respectively of Obvenca) and for the services of taxpayer's treasurers.

11/ The retained earnings should be $99,239 and not $99,259 as found by the Tax Court.

Obvenca, a shell-like subsidiary which had only one full-time employee,[12/] which owned assets valued at only $4,369, which had no office or post office box of its own but used that of its accountant, which had capital of only $6,000 and whose correspondence was handled by taxpayer from its Compton, California, office (I-R. 43-44) was able to report net income for the tax year in question in an amount four times as large as that of its parent. This is a classic example of arbitrary income shifting if there ever was one.

The case of Hall v. Commissioner, 294 F. 2d 82 (C.A. 5th) bears out this conclusion. In that case, the taxpayer manufactured equipment for the cementing of oil wells. Taxpayer operated in the United States under a partnership known as the Weatherford Company. Prior to 1947, the selling and servicing of taxpayer's equipment in Venezuela was handled by an unrelated third party who was paid a 20 per cent commission for such activity. In July, 1947, Hall formed a Venezuelan corporation with capital of only $8,000. The Venezulean corporation, known as Spring Company, then entered into an agreement with Hall, whereby Spring was designated as the representative and distributor of Hall's products in foreign countries. Under this contract, Spring was to pay Hall the manufacturer's cost of such product plus 10 per cent. The Commissioner of Internal Revenue determined

12/ There was even a period of time after Mr. Newman left the employ of Obvenca when taxpayer had no one in Venezuela to represent it.

that an allocation of income under Section 45 of the Internal Revenue Code of 1939 was necessary. Accordingly, the Commissioner required Hall to take into income the full selling price of the items sold to Spring for resale to third parties, less a 20 per cent commission paid to Spring for selling and servicing taxpayer's products. That is, the Commissioner allowed Hall to deduct the same rate of commission which Hall had previously paid to unrelated third parties for the same services. The determination of the Commissioner was upheld by the Tax Court which found taxpayer to have arbitrarily shifted income from the Weatherford Company to Spring. The Tax Court in turn was affirmed by the Fifth Circuit which found (p. 85) that "most of the income which would have been realized by Hall as sole proprietor of the Weatherford Company was shifted to Spring Company." Thus, the Commissioner's reallocation of income on the basis of commissions previously paid to unrelated third parties was upheld. Hall v. Commissioner, supra, therefore supports the determination by the Commissioner that taxpayer should be allowed to deduct only that rate of commissions and discounts which it had paid to Baritina before its contract with Obvenca and which it agreed to pay to Milwhite after the contract with Obvenca was entered into.

Frank v. International Canadian Corp., 308 F. 2d 520 (C.A. 9th), does not support the position of taxpayer. An

examination of the facts of that case quickly reveals its inapplicability here. First, this Court there stated (p. 528):

> We might well find that the Commissioner stipulated himself out of court on this issue. The Pretrial Order states that upon admitted facts (Tr. p. 30) the district court "may find (Tr. p. 34) any one of the following to be the ultimate conclusions of fact and law in this case."
>
> Each of the four alternate ultimate conclusions referred to "a *reasonable price and profit*" as between the two corporations, or to "a reasonable price." (Emphasis added.)
>
> The Commissioner now departs from the Pretrial Order and urges a standard different from that stipulated to by the parties* * * and different from that used by the district court. This he cannot do.

Secondly, and more important, this Court emphasized the fact that the Commissioner there failed to present evidence which would indicate that the parent favored the subsidiary in its contract with the subsidiary or to establish that the mark-up on the two products which the parent sold to its subsidiary was any different from the mark-up on the sale of the same two products to any other customer. This Court there stated (p. 529):

> The Commissioner only estimated Washington's mark-up on other sales; he does not show Washington's mark-up on the *two* products which it sold to International to be any different from Washington's mark-up on the sale of the same *two* products to other customers. Washington sold *many* other products. The Commissioner presents no record evidence showing the profit margins for Washington's different products. Indeed, the Commissioner cannot show record evidence of these profit margins, for he did not inquire into these matters at the trial.

Polak's Frutal Works, Inc. v. Commissioner, 21 T.C. 953, similarly fails to support the position of taxpayer. The Tax Court there stated (p. 976):

> All probative evidence of record is to the effect that Frutal received from the export entities what would be considered in the trade of which it was a part as fair and reasonable prices for its services. Respondent offers no countervailing evidence. Nor does he say what, in his opinion, would constitute such fair and reasonable price. Rather, he would arbitrarily allocate each year whatever percentages of income of the export entity involved is sufficient to bring Frutal's earnings to approximately the level they held in the years prior to the organization of Export.

In the instant case, however, the record evidence clearly shows that the allocation made by the Commissioner under Section 482 was based upon the actual experience of the taxpayer in dealing with uncontrolled parties both immediately prior to and after taxpayer entered into the contract with Obvenca.

Taxpayer contends (Br. 42-43) that since it retained a slightly higher percentage of direct profit from export sales than from domestic sales, even after allowance of the commissions and discounts to its subsidiary in accordance with their contract, it has established that it retained a reasonable return. Taxpayer, however, introduced no evidence to show that the percentage return retained by taxpayer on domestic sales would represent a reasonable return on its export sales. Taxpayer also fails to point out that during the fiscal year in question, which was the

first full year when the rates being allowed to Obvenca were in effect, taxpayer's percentage return on export sales was the lowest it had been since 1956 and was only 54 per cent of what it had been the year before. (I-R. 46.) Thus, it can be seen that the increase in the rate of commissions paid and deductions allowed by taxpayer to its wholly owned subsidiary over that which it had allowed to a third party had the effect of distorting taxpayer's income from what it would have been had the negotiations between taxpayer and Obvenca been at arm's length.

Finally, taxpayer argues (Br. 47) that the effect of the Tax Court's opinion with regard to those sales of taxpayer's products which were made in Colombia, Peru and Mexico was not only to allow Obvenca no profit on such sales, but to require it to operate at a loss. As to the first part of taxpayer's contention, taxpayer has shown no services performed by Obvenca which would entitle it to a profit on the sales in the above countries. (I-R. 51.) As for the second part of taxpayer's contention, the Tax Court found the contractual subagents of Obvenca to actually be taxpayer's distributors. (I-R. 48.) Accordingly, any expense borne by Obvenca with regard to the sale activities in Colombia, Peru and Mexico was an expense of the taxpayer and no deduction therefore could be claimed by Obvenca. Rather, Obvenca would have to look to taxpayer for reimbursement.

CONCLUSION

For the reasons stated above, the decision of the Tax Court should be affirmed.

Respectfully submitted,

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FEBRUARY, 1966.

## CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: ______________ day of ______________, 1966.

______________________________
Attorney

## APPENDIX

Internal Revenue Code of 1954:

### SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

(26 U.S.C. 1958 ed., Sec. 482.)

Treasury Regulations on Income Tax (1954 Code):

### Sec. 1.482-1 Determination of the taxable income of a controlled taxpayer.

(a) Definitions. When used in this section--

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisible or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one or two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) Scope and purpose. (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the

property and business of each of the controlled taxpayers. If however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated taxable income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) Application. Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to

the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(26 C.F.R., Sec. 1.482-1.)